No. 158

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

THOMAS B. LILLY and HELEN W. LILLY, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioners, Thomas B. Lilly and Helen W. Lilly, pray that a writ of certiorari be issued to review the decision of the United States Court of Appeals for the Fourth Circuit in the above case.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (App. 176-196),[1] Judge Arundell dissenting (App. 196-199), is reported in 14 T. C. 1066. The opinion of the United States Court of Appeals for the Fourth Circuit (R. 224) is reported in 188 F. (2d) 269.

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[1] "Tr" designates references to portions of the transcript of the testimony printed in the Appendix to the petitioners' brief in the Court below. "App." designates other portions of the same Appendix. "R." refers to additional portions of the printed record.

JURISDICTION.

The judgment of the United States Court of Appeals was entered on April 2, 1951. (R. 224.) The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1), 62 Stat. 928.

QUESTIONS PRESENTED.

During the taxable years the petitioners were engaged in the optical business. Pursuant to agreements with various eye doctors, which reflected an established and widespread industry practice, the petitioners regularly credited and paid one-third of the price charged for glasses to the doctor who prescribed the glasses for the customer. The questions presented are:

1. Whether the amounts credited and paid to the doctors were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as ordinary and necessary expenses of doing business.

2. Whether the courts below erred in holding that these amounts were not deductible under Section 23(a)(1)(A) of the Internal Revenue Code because of public policy.

STATUTE INVOLVED.

The statute involved is Section 23(a)(1)(A) of the Internal Revenue Code.

> "SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) Expenses—
>
> (1) Trade or business expenses—
>
> (A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

STATEMENT OF FACTS.

The petitioners are husband and wife, who in 1943 and 1944 were engaged in the optical business. As partners they owned and operated the City Optical Company, with offices in Wilmington, Fayetteville, and Greensboro, North Carolina, and in Richmond, Virginia. In addition, petitioner Helen W. Lilly owned and operated the Duke Optical Company in Fayetteville, North Carolina. (App. 163, 176-177.)

For many years before 1920 eye doctors or oculists customarily sold glasses to their patients. After examining the patient's eyes, the doctor would buy the necessary frame and lenses from a wholesale optician, and then resell the finished glasses to the patient. The doctor would keep the difference between the wholesale price paid to the optician and the larger retail price paid by the patient. Many doctors still do their own "dispensing," that is, they buy the lenses and frame and resell them to the patient. The physician's gain consists of a fee for services and the difference between the wholesale price and the retail price of the glasses. (Tr. 68, 155, 180, 184-185, 192, 220, 222, 234, 236, 326, 414-415, 491; App. 179.)

In 1922, when Mr. Lilly organized the City Optical Company, another practice was firmly established in the optical industry. Instead of buying and reselling the glasses, many doctors referred their patients to designated opticians, who would directly furnish and fit the glasses, and charge the patients a retail price. Pursuant to agreement between the optician and the doctor, the former would remit a portion of the retail price to the latter. This arrangement did not increase the price which the patient would otherwise pay for the glasses. At the same time the doctor's gain was somewhat diminished because the optician included a fitting charge in his price. It was felt that this arrangement was superior to the other because the patient obtained better service when the glasses were fitted and adjusted. (Tr.

68, 69, 174, 192, 207, 215, 216, 222, 234, 241, 326, 376, 390, 422, 423, 491, 512-513; App. 176.)

The practice of rebates to doctors was widespread throughout the taxable years 1943 and 1944, as well as the intervening taxable years after 1922. In accordance with this trade practice the petitioners paid a number of doctors one-third of the price received on the sale of glasses to their patients.[2] The petitioners would not have been able to operate successfully if they had failed to abide by the established trade practice of rebates. Physicians were unwilling to surrender the available differential between the wholesale and retail prices unless they were assured of the customary rebate. (Tr. 68-69, 70, 154, 155, 174, 215, 216, 222, 234, 242, 326, 403, 404, 413-414, 421, 430; 490, 498; App. 176.)

The respondent determined deficiencies for 1943 and 1944 on the ground that the rebates were not deductible items. He therefore increased the petitioners' taxable income in the following amounts for the following years:[3]

Year	City Optical Company	Duke Optical Company
1942	$57,063.45	
1943	61,601.95	$6,568.87
1944	60,021.65	4,798.35

In terms of the City Optical Company's taxable income as recomputed by the respondent, the disallowed rebates exceeded 56 per cent of the Company's taxable income for 1942, 61 per cent of its taxable income for 1943, and 68 per cent of its taxable income for 1944. In terms of the Duke Optical Company's taxable income as similarly adjusted, the disallowed rebates exceeded 72 per cent of the Com-

[2] In the taxable years payments were made to as many as 43 physicians. (App. 168-173.)

[3] The year 1942 is involved in the calculation of tax for 1943 because of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 6.

pany's taxable income for 1943 and 63 per cent of its taxable income for 1944. (App. 2, 5, 161-175, 176, 179.)

The Tax Court sustained the respondent's adjustments in regard to the rebates (App. 176-196), with Judge Arundell dissenting. (App. 196-199.) The Court of Appeals affirmed the Tax Court's decision. (R. 229 .) In the case of petitioner Thomas B. Lilly the income tax deficiencies are $54,952.67 for 1943 and $19,301.68 for 1944. In the case of petitioner Helen W. Lilly the income tax deficiencies are $26,685.29 for 1943 and $23,167.14 for 1944. (App. 199-200.)

SPECIFICATION OF ERRORS TO BE URGED.

The Court of Appeals for the Fourth Circuit erred:

1. In holding that the amounts paid to the physicians were not deductible as ordinary and necessary business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.

2. In holding that the amounts paid to the physicians were not deductible under Section 23(a)(1)(A) because of public policy.

3. In affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT.

I. The decision of the Court of Appeals is in conflict with decisions of this Court and decisions of other Courts of Appeals.

Under Section 23(a)(1)(A) a taxpayer may deduct all "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The Court of Appeals did not dispute that the rebates to the physicians were incurred in carrying on a trade or business. Nor did the Court deny that the rebates were "ordinary" and "necessary" outlays in the conduct of the business. Nevertheless the Court disapproved the deduc-

tion on the ground that the allowance would frustrate public policy. But as Section 23(a)(1)(A) readily reveals and as this Court has repeatedly indicated, that provision specifies its own criteria of deductibility. In applying criteria which are nowhere to be found in the statute, the decision of the Court of Appeals is in sharp conflict with basic principles articulated by this Court.

"What class of outlays may, in relation to the federal income tax, be deducted from gross income and in what amount are matters solely for Congress." The "only problem is to ascertain what provisions Congress has made regarding such expenditures as those for which the petitioner claims the right of deduction." *McDonald* v. *Commissioner*, 323 U. S. 57, 59 (1944). Here the provisions which Congress has made are quite clear and specific. The expense must be a "business" expense; and it must be both "ordinary" and "necessary." The statute provides no less and no more.

This Court has held that an outlay is a business expense if it "is directly connected with" or "proximately resulted from" the taxpayer's business. *Kornhauser* v. *United States*, 276 U. S. 145, 153 (1928). See further *Trust of Bingham* v. *Commissioner*, 325 U. S. 365, 373-374 (1945). This Court has also declared that an expense is "ordinary" if it is "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," or "embraced within the normal overhead or operating costs" of the enterprise. An "extremely relevant" consideration "is the nature and scope of the particular business out of which the expense in question accrued." *Deputy* v. *du Pont*, 308 U. S. 488, 495, 496 (1940). Or as this Court previously stated in *Welch* v. *Helvering*, 290 U. S. 111 (1933), in determining what is ordinary, "we have recourse to any fund of business experience, to any known business practices." "The standard set up by the statute is not a rule of law; it is rather a way of life." Hence our guide is "the ways of conduct and the forms of speech prevailing

in the business world." *Id.* at 114, 115. Finally, this Court has held that an expense is "necessary" if it is "appropriate and helpful" in the conduct of the business concerned. *Id.* at 113. See also *Commissioner* v. *Heininger,* 320 U.S. 467, 471 (1943). Cf. *Commissioner* v. *Flowers,* 326 U.S. 466, 470 (1946).

In view of the principles enunciated by this Court, the rebates were clearly deductible. In the language of this Court's opinion in *Commissioner* v. *Heininger, supra,* at 471; the payments were plainly "both 'ordinary and necessary' if these words be given their commonly accepted meaning." By the same token there was no basis for the Court of Appeals' conclusion other than "some unexpressed spirit outside the bounds of the normal meaning of words." *Addison* v. *Holly Hill Co.,* 322 U. S. 607, 617 (1944). Needless to say, the rebates were "directly connected" with the petitioners' business. They were intimately related not only to the business, but to the production of income for the business. Cf. *Trust of Bingham* v. *Commissioner, supra,* at 373-374. They were certainly "ordinary," since they were "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," and included in "the normal overhead or operating costs" of the business. In paying the rebates the petitioners simply conformed to "the ways of conduct" of the "particular business" in which they were engaged. And the rebates easily qualified as "necessary." Indeed they were more than merely "appropriate and helpful." They were unavoidable if the petitioners were to compete successfully in an industry where the custom of rebates was firmly entrenched through no choice of the petitioners.

The Court of Appeals fell into grave error by assuming that in *Commissioner* v. *Heininger, supra,* this Court approved some extra-statutory principle of public policy forbidding the deduction of outlays which are otherwise well within the language of Section 23(a)(1)(A). In the *Heininger* case this Court observed that "The Bureau of Inter-

nal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in Section 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct." 320 U. S. at 473. But in making this observation, this Court hardly endorsed by indirection any vague doctrine of public policy as a criterion of deductibility for tax purposes. This Court merely indicated that even the nebulous notion of public policy, which lower courts had at times approved, did not bar the deduction in controversy. See *id.* at 475. In fact, the *Heininger* opinion pointedly noted that this doctrine "narrowed the generally accepted meaning of the language used in Section 23(a)." In the same connection the opinion explicitly stated that "the language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible." And this Court then indicated that the tax laws do not "penalize illegal business by taxing gross instead of net income." *Id.* at 474. Clearly this statement rejects any vagrant principle of public policy. For under any such theory illegal business should not be allowed any deductions on the ground that deductions aid and encourage taxpayers to engage in unlawful activities.

The rebates incurred by the petitioners were plainly deductible under the *Heininger* decision. In summarizing the scope of that decision as it applies here, we cannot do better than quote from Judge Minton's opinion in the same case for the Court of Appeals for the Seventh Circuit. "If the deduction in the case at bar was not an ordinary and necessary expense to the 'carrying on' of the business, we are unable to understand the English language. Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that

which gives life is not ordinary and necessary." *Heininger v. Commissioner*, 133 F. (2d) 567, 570 (C.A. 7, 1943).

Even if the meaning of Section 23(a)(1)(A) is mysteriously hedged by some doctrine of public policy, the decision of the Court of Appeals is nevertheless in conflict with *Commissioner v. Heininger, supra,* and decisions of other Courts of Appeals. In *Commissioner v. Heininger, supra,* the taxpayer was a dentist who made and sold false teeth in a mail order business. The Postmaster General issued a fraud order against him on the ground that his statements tended to mislead prospective customers or to misrepresent the quality of his product. The taxpayer sought an injunction against the fraud order, but his efforts ultimately failed. During the litigation he incurred lawyer's fees and related legal costs, which he later deducted in computing his federal income taxes. As in the present case, the Commissioner strenuously argued that Section 23(a)(1)(A) does not sanction any deduction which contravenes public policy. This Court rejected the argument for reasons which equally apply here and which the Court of Appeals misunderstood.

If the outlays "are to be denied deduction," this Court stated in the *Heininger* case, "it must be because allowance of the deduction would frustrate the sharply defined policies" of the postal statutes "which authorize the Postmaster General to issue fraud orders. The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators; such punishment is provided by separate statute, and can be imposed only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime."[4] Hence it followed "that to allow the deduction" of the expenses "would

[4] The opinion further stated that the postal statutes were not designed to deter alleged offenders from employing counsel in defense to a fraud order.

not frustrate the policy of these statutes; and to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding." *Id.* at 474-475.

The reasoning of this Court peculiarly applies here. No federal or state statute imposed any "personal punishment" on the petitioners because of their payments to physicians. For that matter the petitioners, unlike the taxpayer in the *Heininger* case, were not subject to any statute or rule of law designed to deter them from the questioned business practice.[5] The payments had not the remotest stigma of illegality.[6] In denying the deduction the Court of Appeals necessarily attached "a serious punitive consequence" upon the petitioners where none was otherwise imposed upon them. The Tax Court has candidly conceded that "the effect" of its decision in this case "was to penalize the optician." See *Weather-Seal Manufacturing Co.*, 16 T. C. No. 158 (1951).

The Court of Appeals reasoned that the agreements between the petitioners and the physicians were contrary to public policy because the rebates violated the fiduciary responsibility of the physicians to their patients. The alleged violations consisted of the doctor's "secret profits through dealings with his patients." (R. 228 .) But even if we extend the utmost credit to this reasoning, the Court of Appeals merely established that the agreements were contrary to public policy in the sense that a physician would not be able to recover upon them. Cf. *Reilly* v. *Beekman*, 24 F. (2d) 791 (C. A. 2, 1928), on which the Court of

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[5] The two states which frown on the payment of rebates have considered it necessary to impose penalties by legislation. See California Business and Professional Code (Deering, 1949 Pocket Supp.) §§ 650, 652; Remington's Revised Statutes of Washington, Annotated (1949 Supp.) § 10185-14.

[6] There is no question of tax avoidance. The physicians regularly reported the rebates as taxable income. (Tr. 28, 40, 59-60, 76, 137, 143, 148, 153, 159.)

Appeals relied. The rule of law implicit in the physician's inability to recover is exclusively directed against the physician and is solely designed to prevent him from collecting the promised payment. The rule does not even attempt "to impose personal punishment" on the physician. On no theory would the doctor's inability to enforce payment be deemed a penalty for an unlawful act. See *Jerry Rossman Corporation* v. *Commissioner*, 175 F. (2d) 711, 712 (C. A. 2, 1949). In disallowing the deduction of the rebates, the Court of Appeals affirmatively punished the petitioners by virtue of a rule of law which is not at all aimed at them and does not purport to punish anyone else. In short, the petitioners have been punished because the doctors allegedly misbehaved.

Aside from its sharp conflict with this Court's *Heininger* opinion, the reasoning of the Court of Appeals is irreconcilable with the opinion in *Jerry Rossman Corporation* v. *Commissioner, supra.* In that case the Court of Appeals for the Second Circuit held that under the *Heininger* decision fines and forfeitures are deductible, depending "upon the place of sanctions in the scheme of enforcement of the underlying act." The Court expressly rejected any rigid rule that a taxpayer may not deduct payments resulting from a violation of statute or some other manifestation of policy. 175 F. (2d) at 713. Instead the Court held that a penalty is deductible if the allowance does not "frustrate" any "sharply defined policies" of the act imposing the penalty. Under the *Rossman* decision the petitioners' rebates were clearly deductible, and in holding otherwise the Court of Appeals for the Fourth Circuit contradicted the animating principle of that decision. For, in this case, unlike the *Rossman* case, no "sanction" whatever was imposed upon the petitioners which the deduction could conceivably frustrate. In fact, the petitioners were not even subject to the slightest "scheme of enforcement."

The decision of the Court of Appeals ultimately rests on the premise that a payment which derives from a private

wrong is non-deductible. This premise collides head-on with decisions of other Courts of Appeals. In *Anderson* v. *Commissioner,* 81 F. (2d) 457 (C. A. 10, 1936), the Court of Appeals for the Tenth Circuit approved the deduction of damages assessed against a taxpayer because of negligence resulting in death. In *Helvering* v. *Hampton,* 79 F. (2d) 358 (C. A. 9, 1935), the Court of Appeals for the Ninth Circuit sustained the deduction of outlays which the taxpayer incurred because of fraudulent behavior in the course of business. "We cannot agree," the opinion stated, "that private wrongdoing in the course of business is extraordinary within the meaning of the taxing statute allowing deductions for ordinary and necessary expenses. The statute itself makes no such exception . . . ." *Id.* at 360.[7] As these and many other cases have held,[8] business outlays due to private wrongs are deductible expenses though all private wrongdoing is contrary to public policy. The decision of the Court of Appeals is necessarily in conflict with this rule, even if we assume, as the respondent contends, that the petitioners were parties to a civil wrong.

II. The proper disposition of this case involves an important question of law which should be settled by this Court.

This case raises a critical question in the administration of the federal income tax laws. Nothing in Section 23(a) (1)(A) or in any Treasury regulation grants or denies deductions in terms of "public policy." Cf. *Commissioner* v.

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[7] In the *Heininger* case this Court seems to have approved the *Hampton* decision. See 320 U. S. at 472, n. 6.

[8] See *Becker Bros.* v. *United States,* 7 F. (2d) 3 (C. A. 2, 1925) (infringement of patent); *H. M. Howard,* 22 B. T. A. 375 (1931) (misrepresentation and conspiracy); *W. R. Hervey,* 25 B. T. A. 1282 (1932) (violation of usury laws); *International Shoe Co.,* 38 B. T. A. 81 (1938) (conspiracy); *Robert S. Farrell,* 44 B. T. A. 238 (1941) (unlawful acts as director); *William Ziegler, Jr.,* 5 T. C. 150 (1945) (mismanagement of corporation). See further I. T. 3627, C. B. 1943, p. 111; I. T. 3762, C. B. 1945, p. 95; O. D. 978, C. B. 5, p. 135 (1921).

Heininger, supra, at 470.[9] The statute specifically states what outlays are deductible. May the respondent, in his discretion, suspend the operation of Section 23(a)(1)(A) in the name of "public policy" where that provision otherwise clearly grants a business deduction? May the respondent, in supposedly enforcing the income tax, exercise the prerogatives of a self-appointed censor of business practices?

Needless to say, these issues spread far beyond this immediate case. They reach into every nook and cranny of business life which is increasingly controlled and supervised by government. Each public regulation reflects a "public policy," and any outlay due to a deviation from that "policy" is necessarily involved in the principle which the respondent seeks to apply. Nor does the reach of this principle pause at the shifting borders of public regulation. As the Court of Appeals' decision vividly illustrates, the principle cuts deep into the whole complex of private relations between businessmen. Indeed no limitation is in sight, for a principle of so-called "public policy" is conveniently free from any restrictions which a rule of tax law normally implies.[10] "The meaning of the phrase 'public policy' is vague and variable; there are no fixed rules by which to determine what it is." *Steele* v. *Drummond,* 275 U. S. 199, 205 (1927).[11] See also *Twin City Co.* v. *Harding Glass Co.,* 283 U. S. 353, 356 (1931). The answer given by the Court of Appeals in this case assures a swelling volume of litigation unless this Court expeditiously intervenes. Cf. *Moline Properties* v. *Commissioner,* 319 U. S. 436 (1943).

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[9] Aside from denying deductions for federal tax penalties, the regulations broadly authorize the deduction of "ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business." Regulations 111, § 29.23(a)-1.

[10] Compare I. T. 3724, C. B. 1945, p. 57, and I. T. 3811, C. B. 1946-2, p. 70, with *Lela Sullenger,* 11 T. C. 1076 (1948).

[11] In the same case this Court warned that the principle of public policy "must be cautiously applied to guard against confusion and injustice." See *id.* at 205.

Already the opinions of the Courts of Appeals are hopelessly confused.[12] And the difficulties which nourish the confusion "can neither be met nor avoided by spurious interpretations of tax provisions dealing with allowable deductions." *McDonald v. Commissioner, supra,* at 63. For example, the Fifth Circuit has stated that under "the broad definition of gross income, income arising from an illegal business is taxed even though the illegality be one declared by the Constitution itself .... The provisions of the statute fixing the deductions to be regarded in arriving at the net income which alone is taxed . . . are as broad and unqualified as those defining the taxable gross income." *Alexandria Gravel Co.* v. *Commissioner,* 95 F. (2d) 615, 616 (C. A. 5, 1938). See also *Heininger* v. *Commissioner, supra,* at 569. According to another view, fines and penalties are never deductible as business expenses, whether they are deliberately or inadvertently incurred. See, *e.g., Great Northern Ry.* v. *Commissioner,* 40 F. (2d) 372 (C. A. 8, 1930), *cert. denied,* 282 U. S. 855 (1930); *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner,* 47 F. (2d) 990 (C. A. 7, 1931), *cert. denied,* 284 U. S. 618 (1931). On the other hand, it has been held "that there are 'penalties' and 'penalties', and that some are deductible and some are not." The determinative factor is "the place of sanctions in the scheme of enforcement of the underlying act," and "in every case the question must be decided ad hoc." *Jerry Rossman Corporation* v. *Commissioner, supra,* at 713. According to still another view, penalties are deductible unless they are due to "an unreasonable lack of care." *National Brass Works* v. *Commissioner,* 182 F. (2d) 526, 530 (C. A. 9, 1950).

The confusion does not abate when we pass beyond the realm of public regulations into the realm of private rela-

[12] We should also note that the Treasury, too, is often confused in applying its doctrine of public policy. For instance, compare P. H. 1950 Fed. Tax Law, Par. 76,321, with I. T. 4042, Int. Rev. Bull., 1951, No. 1, p. 3.

tions. As previously noted, many decisions have held that a business outlay attributable to a private wrong is a deductible expense. See p. 12, *supra*. In contrast, the Court of Appeals has held in this case that an outlay reflecting an alleged transgression of private rights is not deductible. Unless "an arbitrary line" is drawn, it is quite a job to reconcile the decisions which allow the deduction of expenses deriving from a private wrong with the decisions which deny the deduction of outlays deriving from a public wrong. *Burroughs Building Material Co.* v. *Commissioner*, 47 F. (2d) 178, 180 (C. A. 2, 1931). In both cases "public policy" is equally involved and equally violated. Business fines and penalties have been disallowed on the ground that a tax deduction would partially mitigate the sanction incurred. See *Great Northern Ry.* v. *Commissioner, supra*, at 373; *Commissioner* v. *Longhorn Portland Cement Co.*, 148 F. (2d), 276, 277 (C. A. 5, 1945), *cert. denied*, 326 U. S. 728 (1945). But the deduction of damages imposed because of a private transgression equally mitigates the sanction imposed upon a taxpayer for his wrongful conduct.[13]

The decision of the Court of Appeals in this case nicely exemplifies the endless confusion which the principle of "public policy" inevitably breeds. The Court of Appeals did not deny that the questioned payments, apart from public policy, qualified as ordinary and necessary business expenses. However, the Court reasoned that the payments were not deductible because they failed to satisfy the standards of equity as compared with the standards of the market place. In support the Court quoted Mr. Justice Car-

[13] "Undoubtedly expenditures which are in themselves immoral, such as for bribery of public officials to secure protection of an unlawful business, would not have to be allowed in order consistently to justify a deduction of fines paid for violations of law involving no moral turpitude and practically inevitable." *Burroughs Building Material Co.* v. *Commissioner, supra*, at 180. Cf. L. O. 1092, C.B.I-1, p. 270 (1922), distinguishing between illegal transactions and merely unenforceable contracts.

dozo's famous admonition that many "forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard* v. *Salmon*, 249 N. Y. 458, 464, 164 N. E. 545, 546 (1928). This quotation leaves no doubt of the Court of Appeals' confusion. The present controversy is not a suit in equity, nor was Section 23(a)(1)(A) devised as a means of enforcing the standards of equity as they may variously evolve in the state courts. The question in this case is one of federal income tax liability, and the answer turns on the meaning of a statute devoted to "the single uniform purpose of federal taxation." *Estate of Rogers* v. *Commissioner*, 320 U. S. 410, 414 (1943). See also *Lyeth* v. *Hoey*, 305 U. S. 188, 193 (1938); *United States* v. *Pelzer*, 312 U. S. 399, 402 (1941). That purpose contemplates a tax on business income after allowance for all business expenses which are "ordinary" and "necessary" according to "the ways of conduct and the forms of speech prevailing in the business world." *Commissioner* v. *Heininger*, *supra*, at 471. In its anxiety to apply a principle of equity, wholly unrelated to federal taxation, the Court of Appeals overlooked the language and policy of Section 23(a)(1)(A). Just as the allowance of deductions under that provision does not depend upon "equitable considerations" (*Deputy* v. *du Pont*, *supra*, at 493), neither does their denial.[14]

[14] The Court of Appeals' opinion additionally indicates that "public policy" easily leads into a quagmire of conceptualism divorced from relevant fact. The opinion argued that the agreements between the petitioners and the physicians were unenforceable because they tended to corrupt the latter into prescribing unnecessary or unduly expensive glasses, recommending an inferior optician, and artificially increasing the price of glasses. However, the record establishes that the physicians' services and the petitioners' prices remained the same, whether or not the referred patient bought his spectacles from the petitioners. Moreover, the payment of rebates was not a practice inaugurated by the peti-

A principle which is confusing and elusive in content is inevitably harsh and retroactive in application.[15] Again this case serves as a grim illustration. For many years opticians, including the petitioners, excluded the rebates from their taxable net income and the respondent's agents repeatedly approved the exclusion. Since the rebates were a substantial portion of the opticians' *gross receipts,* the exclusion was necessarily a vital factor in business assumptions, calculations and risks. In the present case the rebates of the City Optical Company for 1942, 1943 and 1944 aggregated \$178,687.05 (App. 179), as compared to a total book value of only \$76,191.32 as of December 31, 1942. (14 T. C. at 1068.) Again, for 1943 and 1944 the rebates of the two Companies varied between 61 per cent and 72 per cent of their taxable income as adjusted by the respondent.[16] Despite its long-continued administrative practice and without any prior warning of a change in position, the Treasury has now reversed itself in the name of public policy. Disastrous financial consequences are inescapable under the retroactive impact of the principle pursued by the respondent. Surely in enacting Section 23(a)(1)(A) Congress did not contemplate "so deadly a remedy" which no word in that statute implies or suggests. Cf. *Bruce's Juices, Inc.* v. *American Can Co.,* 330 U. S. 743, 754 (1947).

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tioners in order to corrupt physicians, but a widespread custom enforced by physicians, to which the petitioners had to conform in order to compete. Again, the practice of rebates no more corrupted the physicians than the other custom whereby physicians lawfully purchased glasses at a wholesale price and resold them at a retail price. Nor is the physician who receives a rebate more tempted to do what the Court of Appeals feared than the physician who runs his own optical business and therefore has a potential financial stake in prescribing glasses. All these considerations sharply underscore the futility of using tax law as a means of policing the integrity of eye doctors.

[15] We need hardly remind this Court of the evils of retroactivity in income taxation. See, *e.g., Helvering* v. *Griffiths,* 318 U. S. 371, 402-403 (1943); *Claridge Apartments Co.* v. *Commissioner,* 323 U. S. 141, 164 (1944).

[16] See p. 4, *supra.*

The present confusion over a steadily expanding area urgently requires the authoritative intervention of this Court. The respondent frankly regards Section 23(a)(1)(A) as a special delegation of power to regulate and disapprove business standards and procedures. As this case reveals, the respondent even assumes that the vast area of professional ethics equally falls within his alleged powers of supervision. Section 23(a)(1)(A) has been converted into a federal policing provision employed to implement not only federal policies, but state policies having nothing to do with federal taxation.

The respondent's view of Section 23(a)(1)(A) completely disregards the clear purport and plain function of that provision. "The revenue act was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State inflicts."[17] Nor was that act contrived in order to assure that businessmen abide by local principles of equity. The respondent's reliance on some notion of public policy is mere question begging. To borrow Mr. Justice Holmes' memorable phrase, the public policy of taxation is not "a brooding omnipresence in the sky" (*Southern Pacific Co.* v. *Jensen*, 244 U. S. 205, 222 (1917)) whose aid the respondent may periodically invoke as he sees fit. The public policy of taxation is the policy which Congress creates, and that policy is expressed in the taxing provisions which Congress has enacted.

In so far as Section 23(a)(1)(A) is concerned, the basic policy of Congress is well beyond the pale of doubt. That provision was not imposed in order to create or enforce a code of business or professional ethics. Certainly there is no indication that the respondents' agents are particularly skilled in the art of regulating trade practices as distinguished from the art of computing and collecting taxes. The sole objective of Section 23(a)(1) (A) is to confine the

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[17] Member Sternhagen, in *Burroughs Building Material Co.*, 18 B. T. A. 101, 105 (1929).

burden of the income tax to net income. "The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax paying group." *Higgins* v. *Smith*, 308 U. S. 473, 476-477 (1940). "Taxation on net, not on gross, income has always been the broad basic policy of our income tax laws. Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it." Black J., *McDonald* v. *Commissioner*, *supra*, at 66-67. See also *id.* at 68-69. Hence Section 23 (a)(1)(A) assures the deduction of "outlays in the efforts or services" from which "income flows." Frankfurter J., *id.* at 60-61. See also Roberts, J., in *Deputy* v. *du Pont*, *supra*, at 500.

In misapplying Section 23(a)(1)(A) the Court of Appeals has raised fundamental issues concerning the scope of that significant statute. Only this Court can set those issues at rest.

Conclusion.

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be granted.

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